

Ramp Up Crypto Reporting Now, Say Tax Pros

by Kristen A. Parillo

Taxpayers potentially subject to lawmakers' proposed cryptocurrency broker reporting regime should start preparing now, even as the industry continues to push for refinements to the "broker" definition.

Given the likelihood that the reporting rules will be enacted with no amendments — and possibly leaving it to Treasury and the IRS to flesh out who must report — taxpayers will need to stay engaged and develop a plan so they're ready by the anticipated January 1, 2023, effective date, according to practitioners who spoke with *Tax Notes*.

The inclusion of cryptocurrency reporting requirements in the Infrastructure Investment and Jobs Act (H.R. 3684) kicked off weeks of intense lobbying by the cryptocurrency industry.

The bill would require Form 1099 transaction reporting by cryptocurrency and other digital asset brokers, apply the cost basis reporting regime to digital assets, require brokers to report transfers of digital assets to other brokers as well as to non-brokers, and require digital assets to be treated as cash when received in the course of a trade or business.

The most controversial aspect that's been raised is who would qualify as a broker. The bill proposed expanding the definition of broker under section 6045(c)(1) to include "any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person." Industry groups said that language is too broad and could sweep in noncustodial blockchain technology providers, such as miners, network validators, and software developers.

Multiple attempts to limit the definition's scope via amendment failed in the Senate in the days leading up to the bill's August 11 passage in that chamber. The industry and some lawmakers had hoped the provision could be revised after the bill went to the House. But those hopes were dashed when the House agreed August 24 to bring the bill, with no amendments permitted, to a floor vote no later than September 27.

Next Steps

Assuming the reporting provisions will be enacted, how or when they will be clarified remains to be seen.

Sen. Cynthia Lummis, R-Wyo., told reporters August 10 that she hopes a stand-alone piece of legislation will come to the Senate floor before the end of the year that clearly defines broker and other terms used in the digital asset sector. Some news reports have quoted unnamed Treasury officials as saying the government will clarify that the rules won't apply to entities like miners and developers if they don't act as brokers.

For those potentially subject to the new reporting requirements, monitoring the legislative and regulatory developments will be crucial, according to Danielle Nishida of KPMG LLP. With no clear guidelines yet on who qualifies as a broker, any entity engaging in cryptocurrency activity will have to pay attention and consider how it can comply, she said.

"They may not end up being in scope at the end of the day, but since they potentially are in scope now, they have to identify their impact and identify the implementation challenges they would face," said Nishida. Flagging those issues and concerns now will also be useful when Treasury and the IRS begin the rulemaking process and solicit input, she added.

Sarah-Jane Morin of Morgan Lewis & Bockius LLP said that until the broker definition is fleshed out, figuring out the next steps will likely be more difficult for the smaller players. "The larger, centralized exchanges like Coinbase are already doing some type of reporting, so implementing these new obligations may not be as big a deal," she noted.

"It's the noncustodial intermediaries who aren't running a centralized exchange who are probably really concerned about how this definition of broker is going to be clarified," Morin continued. "The smaller shops are worried because they'll need to decide whether to put new infrastructure in their back office to meet these reporting requirements."

Ready Mode

Developing a project readiness plan now will help taxpayers stay on track, said Nishida.

Implementing an information reporting regime is costly and labor intensive, “so you want to have a plan and scope for your future project,” she added.

Taxpayers can put together a general outline of necessary tasks based on the legislative language, Nishida said, adding, “For example, you know that your systems will need to be updated, and you’ll have to figure out how to incorporate cost basis functionality into them.”

For taxpayers already doing some kind of cryptocurrency reporting, “they’ll need to determine what the delta is between what they’re doing now and what will be required under the new legislation,” Nishida said.

Deciding which tasks can be done in-house and which can be outsourced is another item to tackle, Nishida said. She added that taxpayers should also have a governance structure in place specifying duties and responsibilities so that staffers are ready to go when the legislation gets enacted.

Charles S. Kolstad of Withers said some taxpayers may need to add customer support personnel, or train existing staff, to explain the new rules and address any client inquiries. “There are a lot of practical implementation issues that haven’t really been thought about yet that are going to create complications and disrupt businesses,” he noted.

Open Issues

In addition to getting a clearer picture of who qualifies as a broker, stakeholders will need to address a host of other technical issues.

“At the top of my list is how are brokers going to assign basis from cryptocurrency that comes in from a third-party wallet?” said James Creech of Baker Tilly US LLP. “Without some sort of basis number, the [Forms] 1099 that exchanges issue are going to be wrong. This will lead to angry users when the inevitable matching notice comes out the following year.”

While advisers have repeatedly warned taxpayers who engage in cryptocurrency trading that tracking basis is important, many of them have wallets with commingled coins and no idea what their basis is or what first-in, first-out means, according to Creech. “I imagine we are going to have to see some sort of self-certification as to

basis, or a user fee for coin tracking software to generate a basis report when you transfer something into a covered brokerage account — but that’s just speculation,” he said.

Another open question, said Creech, is how platforms like OpenSea, a peer-to-peer marketplace for crypto collectibles and non-fungible tokens, and stablecoin provider Tether intend to adopt the new rules. “They aren’t necessarily retail exchanges like Coinbase, and OpenSea in particular is new, so what kind of compliance mind-set do they have?” he wondered. “It is all to be determined, but that is what makes this interesting.”

According to Kolstad, determining an appropriate valuation method is another issue that needs to be tackled. “There can be dramatic swings in value during the day, so you can’t just use close-of-business price,” he said.

Kolstad noted that there are service providers that can calculate the value of a cryptocurrency at an exact date and time. “But if there are four services that can value Ether or Ripple or whatever, how do you decide which one to use?” he asked. “Perhaps the IRS can simply say, whatever you pick you have to use on a consistent basis.”

Dealing with a tight deadline may be the biggest challenge, said Nishida, who noted that the proposed rules have an effective date of January 1, 2023. “Once the legislation is passed, it’s going to take some time for Treasury and the IRS to issue regulations, and the industry will need time to absorb and act on them,” she said. “A lot of these systems changes can take at least a year to build. It doesn’t look like this timetable is very practical.” ■